AGENDA DATE: 3/31/99
AGENDA ITEM:

State of New Jersey
Board of Public Utilities
Two Gateway Center
Newark, NJ 07102

<u>ENERGY</u>

IN THE MATTER OF CONSIDERATION)
OF THE JOINT PETITION OF ORANGE)
& ROCKLAND UTILITIES, INC. FOR)
APPROVAL OF THE AGREEMENT AND PLAN)
OF MERGER AND TRANSFER OF CONTROL)

<u>ORDER</u>

DOCKET NO. EM98070433

(Service List Attached)

BY THE BOARD:

On July 6, 1998, Orange and Rockland Utilities, Inc. ("Orange and Rockland" or “O&R”), the corporate parent of Rockland Electric Company (RECo) a public utility in the state of New Jersey and Consolidated Edison, Inc. (CEI), the corporate parent of consolidated Edison Company of New York, Inc. (Con Edison) (hereinafter collectively referred to as Petitioners) filed a Joint Petition with the New Jersey Board of Public Utilities (Board) for approval of an Agreement and Plan of Merger and Transfer of Control pursuant to <u>N.J.S.A.</u> 48:2-5.1 and 48:3-10.

On October 27, 1998, a telephone prehearing conference was held. On November 2, 1998, objections to the proposed resulting schedule were filed by The Division of the Ratepayer Advocate and Petitioners' response thereto was filed on November 4, 1998. On November 13, 1998, the Board issued an Order Establishing Procedural Schedule and the matter was retained for hearing by the Board, with Commissioner Carmen J. Armenti presiding.

On December 3, 1998, Petitioners filed a Motion to Strike Testimony concerning portions of the testimony of the Division of Ratepayer Advocate's (DRA) Expert Witness, pertaining to RECo's cost of capital and the level of RECo's proposed rate reduction. On December 7, 1998, the DRA filed its opposition to Petitioners' motion to strike. An evidentiary hearing was held on December 8, 1998 before Commissioner Carmen J. Armenti. At the hearing, after considering the arguments of the parties, Commissioner Armenti denied the Petitioners' Motion to Strike, but allowed RECo to enter into the evidentiary record additional material from the record in RECo's unbundling and stranded cost proceedings in Docket Nos. EO97070464 et al regarding Cost of Capital. Thereafter, briefs and replies setting forth the substantive positions of the parties were timely filed with Commissioner Armenti.

Orange and Rockland is a New York public utility incorporated in New York State. Orange and Rockland is an exempt holding company under the Public Utility Holding Company Act of 1935 ("PUHCA") whose stock is publicly held. It is sole shareholder of both RECo and Pike County Light and Power Company ("Pike"), a Pennsylvania public utility. Orange and Rockland provides electric and gas service to customers in Rockland, Orange, and Sullivan Counties in New York. Collectively, Orange and Rockland, Pike and RECo provide electric service to approximately 269,000 customers and, excluding RECo, gas service to approximately 114,000 customers. RECo currently provides transmission, distribution and electric merchant services only to approximately 66,000 customers in northern parts of Bergen and Passaic Counties and areas of northeastern and northwestern parts of Sussex County, New Jersey.

As of March 31, 1998, Orange and Rockland had total net utility plant of $935.3 million and total shareholders equity of $377.5 million. Total operating revenues for the twelve months ending March 31, 1998 were $628.5 million.

CEI is also an exempt holding company under PUCHA and the corporate parent and sole common shareholder of Con Edison, a public utility in the state of New York, with a principal business office at 4 Irving Place, New York, N.Y 10003, that provides both gas and electric service to approximately 3 million customers in New York City and Westchester County, New York. More specifically, Con Edison provides electric service to New York City (except parts of queens) and most of Westchester County, New York. Con Edison provides gas service in Manhattan, the Bronx and parts of Queens and Westchester County, New York, to approximately 1 million customers and steam service in parts of Manhattan.

As of March 31, 1998, CEI had total net utility plant of $11.3 billion and total shareholders equity of $6 billion. Total operating revenues for the twelve months ending March 31, 1998 were $7.1 billion.

In compliance with the New York Public Service Commission's approved restructuring plan for the electric industry in New York, Orange and Rockland and CEI both separately agreed to divest their non-nuclear generation assets. Consistent with this effort, in November 1998 Orange and Rockland announced that Southern Energy, a division of Southern Company, was purchasing most of Orange and Rockland's generating assets. Plans to completely divest Orange and Rockland's other power generation assets are currently underway. CEI also plans to complete its divestment of generation assets.

Con Edison proposes to acquire all the outstanding common stock of Orange and Rockland for the price of $58.50 per share for a total of $790 million. This represents a premium of 110% over book value of O&R's equity and a 38.5% premium over the stock price of $42.25 prior to the announcement of the merger. The Company proposes to amortize the acquisition premium of $410 million over 40 years below the line.

The proposed transfer of control involves the merger of C- Acquisition Corp, a wholly-owned subsidiary of CEI, with and into Orange and Rockland. Orange and Rockland will become the surviving corporation and a wholly-owned subsidiary of CEI. Petitioners propose that at the completion of the merger, RECo will continue to exist under its current name and as an operating subsidiary of Orange and Rockland and provide service under existing tariffs and service arrangements. The Petitioners have stated that RECo's rate structure will be separate and independent from Con Edison's and that the latter's location-driven higher operating and business costs will not be shifted to RECo.

The Petitioners have set a target date of March 31, 1999 for receiving all necessary approvals from the Federal Energy Regulatory Commission (FERC), the Security and Exchange Commission, the U.S. Department of Justice and Federal Trade Commission, the New York PSC, the Pennsylvania PUC, New Jersey DEP, the Board and finally closing the merger.

DISCUSSION

Standard of Review

The Statutory provisions under N.J.S.A. 48:3-10 require certain approvals of the Board where a public utility, incorporated under the laws of New Jersey, attempts to transfer any shares of its stock to any other public utility. Board approval is also required where any sale of transfer of stock of a public utility vests in any corporation or person a majority interest in the capital stock of the public utility.

The provisions contained in N.J.S.A. 48:2-51.1 are quite different and involve distinct concerns. In pertinent part, this statute provides the template to be used for consideration of requests for approval of acquiring control of a public utility within the Board's jurisdiction. The Board must consider the effect of the acquisition on (1) competition, (2) the rates of ratepayers affected by the acquisition of control, (3) the employees of the affected public utility, and (4) the provision of safe and adequate utility service at just and reasonable rates. Thus, N.J.S.A. 48:2-51. provides:

> No person shall acquire or seek to acquire control of a public utility directly or indirectly through the medium of an affiliated or parent corporation or organization, or through the purchase of shares, the election of a board or directors, the acquisition of proxies to vote for the election of directors, or through any other manner, without requesting and receiving the written approval of the Board of Public Utilities. Any agreement reached, or any other action taken, in violation of this act shall be void. In considering a request for approval of an acquisition of control, the Board shall evaluate the impact of the acquisition on competition, on the rates of ratepayers affected by the acquisition of control, on the employees of the affected public utility or utilities, and on the provision of safe and adequate utility service at just and reasonable rates. The Board shall accompany its decision on a request for approval of an acquisition of control with a written report detailing the basis for its decision, including findings of fact and conclusions of law.

In its Final Decision and Order in I/M/O Petition of Atlantic City Electric and Conectiv, Inc. for approval of a Change in Ownership and Control, January 7, 1998, Docket No. EM97020103, ("Conectiv"), the Board determined that a "no harm" standard should be utilized when reviewing filings seeking approval of a change in control of a public utility under the above statute rather than what is referred to as a "positive benefits" standard. Citing the Administratrive Law Judge's Initial Decision in Conectiv, the Board noted that it has used the no harm standard in the vast majority of cases involving acquisitions and mergers of utilities. After an analysis of the relevant cases, the Board stated:

> [A]dherence to a "no harm" standard is reasonable. In this regard, the Board believes that it would be unreasonable to insist in this case that Petitioners prove that positive benefits will accrue as a result of the proposed merger, when the use of the "no harm" standard is sufficient to ensure the continuation of safe, adequate and proper service at reasonable rates and adherence to the other requirements of N.J.S.A. 48:2-51.1.
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> [Conectiv at 6.]

Therefore, in view of the Board's decision in Conectiv, the Board is using the a "no harm" standard of review in this case. This means that we will approve the proposed transaction in this case if we are satisfied that there will be no overall adverse impact on the provision of safe, adequate and proper service at just and reasonable rates, on employees of the RECo and on competition.

Despite our conclusion that Petitioners need only prove no adverse impact resulting from the merger, Petitioners are proposing that there will in fact be certain "benefits" resulting from the proposed merger. Because the issue of the appropriate treatment of these "benefits" is before the Board, we will examine whether the calculation of these benefits are properly derived by Petitioners and whether under Petitioners' proposal said benefits are equitably shared with ratepayers.

<u>Impact of the Merger on Competition</u>

Petitioners claim that rather than adversely impact competition in RECo’s service territory, the proposed merger would instead enhance it. In addition to the potential benefits to competition created by the Petitioners' planned divestiture of their non-nuclear generating assets, they also assert that other benefits are occasioned by the merger. Thus, it is argued by Petitioners that the merger and in conjunction with divestiture will result in benefits derived from:

i. the creation of a core wires company that would develop the transmission and distribution infrastructure to support technological innovations and information systems vital to the provision of better products and services and for a smooth functioning of competitive markets;

ii. the creation of innovative services (e.g. in metering and billing) through enhanced customer service telecommunications technology, retail access information systems and emergency planning & response at reasonable rates which otherwise without a merger, and thus a smaller and less diverse customer base, may not be developed;

iii. the continuous commitment to further divest generating assets that will prevent vertical market power, introduce competition from new generation supplies, facilitate the mitigation of stranded costs, provide the ability to evaluate stranded costs with more certainty, and eliminate concerns regarding the Board's authority to mandate divestiture; and

iv. the continuous Board regulatory oversight of RECo's utility operations and the Company's obligation to implement the Board's restructuring and retail access program as further guarantees that the required standards of competition will be met.

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The DRA concedes that this merger does not appear to present significant market power concerns but asserts that it nevertheless reduces the number of potential competitive suppliers in the State. The DRA concludes that the merger does not however, produce positive benefits for New Jersey with regard to competition since it results in one less competitor in the competitive products market sector.

Staff

Staff also finds no significant adverse impact on competition particularly given the potential dilution of its market power occasioned by the Petitioners' divestiture of their non-nuclear generating assets. However, Staff argued that if Petitioners should discontinue the divestiture of its assets for some reason, a reevaluation of the market power issue would be warranted.

Board's Ruling:

The Board is convinced by the record in this case that this merger as proposed poses no significant drawback to competition in the New Jersey marketplace for electricity. In fact, it may actually strengthen RECo's ability to competitively participate in the market and assuming the fulfilment of the service enhancements predicted by Petitioners, also improve the quality of RECo's services. Moreover, a significant contributing factor underlying our conclusion that the merger will not adversely impact competitive markets is the previous commitment by both CEI and Orange and Rockland to divest power generation assets, and ongoing activities towards meeting those commitments. Therefore, the **BOARD HEREBY FINDS** that there will be no adverse impact on competition as a result of the merger.

This conclusion notwithstanding, and as stated in Conectiv, the Board has full authority to propound as needed appropriate future regulatory policy to promote competition in the New Jersey electricity marketplace and to discourage the concentration of market power by New Jersey's Electric Utilities. This continuing evaluation will also take into consideration the Petitioners' successful completion of ongoing generation asset divestiture.

The Impact of the Acquisition on RECo's Rates

Petitioners have determined that substantial cost savings will be generated by this merger as a result of the economies of scale and other operating efficiencies. As such, RECo has proposed to allocate 50% of RECo's pro rata share of these savings to ratepayers. A major portion of the savings is labor related and will result from the consolidation of administrative and general (A&G) functions within the corporate and support areas of the merging companies. Considerable non-labor cost savings are also expected to result from the merger including facility costs, overhead, advertising costs, dues, benefits, information technology, insurance, professional services, shareholder services, inventory and procurement. Specifically, the Petitioners ascribe $335 million or 65.4% of the savings to expected reductions in labor costs. Another $106 million or 20.7% of the savings, relate to reductions in corporate and administrative costs.

Petitioners estimate nominal gross merger savings of $511.6 million over a ten year period extending from July 1, 1999 through March 31, 2009. They also estimate the "cost to achieve" the merger at $44.06 million, to yield a gross nominal net savings of $467.54 million. Although the so-called synergy savings are expected to accrue over a ten year span, Petitioners propose to amortize the associated "cost to achieve" over the first five years of the merger. Approximately 26% of the total net savings ($121.9, million) is to be allocated to Orange and Rockland, of which 22% ($26.8 million) will be allocated to RECo as its pro - rata share. The 22% factor is based on the Joint Operating Agreement between O&R and RECo. The savings are expected to emanate from many areas including utility operations, product development and corporate services as the Petitioners achieve greater efficiencies in providing energy and related services.

Petitioners' estimated cost to achieve the merger applies to certain transaction, transition and employee costs. These include investment banking, legal and consulting, information system, integration, regulatory approval costs, as well as employee separation, relocation and training costs.

The employee costs include $6.922 million of executive separation costs, $1 million in relocation costs and $2.5 million of "stay payments." Petitioners describe "stay payments" as incentives paid to retain the services of experienced managers in key positions as the companies transition into the merged entity. Petitioners consider these payments as normal and reasonable costs incurred to achieve the merger and necessary to retain key managers who would likely leave which would cause problems relating to system reliability. Petitioners further assert that these costs should be treated no differently than any other merger related cost. The Petitioners expressly state that the separation payments represent three year's salary for five executives which is customary in mergers and thus reasonable. Petitioners further argue that $27 million of the total synergy savings of $511.6 million represents the savings from not paying these same five executives for all of the ten years.

Petitioners have proposed to share RECo's portion of the net savings with its ratepayers on a 50/50 basis. As such, RECo is offering to reduce rates by $263,000 or 0.2% effective April 1, 1999. This represents 50% of the average net synergy savings allocable to RECo over the first two years of the merger. This would be followed by an additional rate reduction of $608,000 effective April 1, 2001 for a total of $871,000 or 0.6%. This $871,000 aggregate reduction represents 50% of the estimated third year net synergy savings allocable to RECo.

Total additional savings of $12.529 million are estimated by the Petitioners to accrue to RECo's ratepayers by the end of the ten year period following the merger, that is, after March 31, 2002 through March 31, 2009. The determination of actual post-March 31, 2002 synergy savings relies on a formula that compares actual future costs to a base of 1998 costs adjusted for inflation less a productivity factor of 2%.

The Petitioners argue that the DRA failed to provide sound legal or evidentiary judgment for its proposal that the Board Order RECo’s rate reduction refl

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The DRA reduces Petitioners' proposed amount representing the "Cost to achieve" the merger from $44.06 million to $33.638 million by excluding the proposed executive separation costs ($6.922 million), Stay payment cost ($2.5 million) and employee relocation costs ($1 million), for a total cost adjustment of $10.422 million. The DRA regards the executive separation costs to be discretionary "golden parachutes" or "bonuses" for the very officers and management who negotiated the merger with Con Edison. Petitioners' proposal to pay $6.9 million to five current senior executives results in an average payment of approximately $1.38 million per executive which is more than three times their basic salary or $2.3 million annually. It is the DRA's view that the disallowance of such costs eliminates any self-interests of the executives who negotiated the merger. The DRA also rejects the so called "stay payments", arguing that similar costs were denied recovery by the Board in the <u>Conectiv</u> merger case and that in any event, the record does not support the notion that a significant number of employees would leave the Company in anticipation of the merger. The DRA also argues for the exclusion of employee relocation costs because Petitioners have not specified how employees will be reassigned after the merger and because the close proximity of the service territories of Con Edison and Orange and Rockland mitigates the need for relocation.

The DRA further argues for consistency between the Petitioners’ allocation of merger costs and merger savings between Orange and Rockland. While Petitioners' allocate 45% of the total merger costs to Orange and Rockland, the DRA notes that the latter receives only a 27.7% share of the merger savings. The DRA emphasizes that the majority of the anticipated cost savings will result from the elimination of A&G expenses formerly incurred by O&R. The DRA recommends that merger costs be allocated 27.7% to O&R consistent with O&R’s share of merger savings.

Citing the Board's broad regulatory oversight set forth at <u>N.J.S.A</u>. 48:2-51.1, the DRA argues that 100% of the anticipated merger savings be flowed to ratepayers. To support its position in this regard, the DRA argues that the 38.5% premium to be received by Orange and Rockland's shareholders is an ample reward to RECo's shareholders for their investment that should as a result, exclude them from receiving additional benefits from the merger savings. The DRA further argues that under the traditional cost of service basis by which RECo is regulated, all cost savings should be flowed to ratepayers.

Unlike the Petitioners, who have used a 5 year amortization of costs, the DRA, consistent with the treatment of the merger savings, amortizes the merger costs over the same 10-year savings period proposed by the Petitioner. The DRA has also levelized the net savings over 10 years using a discount at the cost of capital of 7.49%. This cost of capital was recommended by the DRA witness, James Rothschild in RECo's Stranded cost and Unbundling proceeding. (<u>I/M/O the Energy Master Plan Phase II Proceeding to Investigate the Future Structure of the Electric Industry</u>, BPU

Docket Nos. EO97070464 and E097070465). Incorporating all its adjustments, the DRA recommends a rate reduction of $2.778 million or 2.04% of RECo's total 1998 revenues effective with the consummation of the merger. This amount represents a ten year levelized amortization of the net present value of RECo's share of net synergy savings as adjusted by the DRA. In addition, as part of its rate reduction proposal, the DRA argues against crediting the merger rate reductions toward the restructuring rate reductions, since it believes this would eliminate all merger savings for ratepayers.

Finally, as a general matter about rates, the DRA warns against allowing the Petitioners to combine and blend RECo's rates with those of Con Edison or other CEI subsidiaries which are substantially higher. The DRA further urges the Board to carefully monitor RECo's future A&G costs since the Petitioners intend for Con Edison to provide O&R with various administrative and general services after the merger. Thus, the DRA recommends that the Petitioners be requested to file a cost allocation manual with the Board.

Staff

In its brief, Board Staff viewed as germane to resolving the savings sharing issue, the significant windfall to be enjoyed by O&R shareholders as a result of the merger. As documented in the record, O&R shareholders stand to experience a gain of 38.5%, or approximately $16.25 per share representing the premium in the acquisition price over the market price per share at the time the merger was announced, for a total shareholder benefit of over $200 million. For this reason, Staff argued that shareholders should not receive additional benefits through a 50% share of the savings generated from cost reductions resulting from the merger.

Staff also argued that in a rate case, where traditional cost of service ratemaking is employed, ratepayers would be entitled to receive 100% of any realized savings. Staff also opposed the 50/50 sharing mechanism proposed by Petitioners and argued that the Board order a reduction in rates by an amount equal to at least a 75% share of the merger savings consistent with the Board's decision in the Conectiv matter.

However, Staff did not challenge the merger savings estimates propounded by Petitioners, but still argued that the savings could be considerably larger. In this regard, Staff pointed to Petitioners' experts' admission in the record that the cost reductions that give rise to the merger savings are permanent and increasing in nature, and will continue indefinitely.

With regard to merger costs, Staff argued that a 10 year amortization period would be appropriate. Staff noted that by amortizing merger costs over the first 5 years, Petitioners would be allocating disproportionately smaller portions of the net savings to ratepayers in the early years after the merger, and because these expenditures will incur benefits many years into the future during which the merger savings will materialize, that these costs should be amortized over the 10 years during which they are expected to generate savings. Staff also noted that the DRA's scheduling of merger costs is consistent with the treatment accorded such cost in the recently approved Conectiv merger.

On the issue of the time table for flowing savings to ratepayers, Staff contended that ratepayers could pay more than the costs of service in future years, should the Petitioners' proposed mechanism be adopted. As noted above, Petitioners propose that savings incurred during the period March 31, 2003 through 2009 be allocated between ratepayers and shareholders on a formula that escalates actual 1998 costs by the consumer price index, and reduces it by a productivity factor of 2% per year. By this formula, net savings in this period would accrue to ratepayers only to the extent that actual future costs when compared to adjusted 1998 costs, show savings. Staff faulted this mechanism because it would deviate from cost based ratemaking principles, and would assign to shareholders, during those years, benefits from cost savings that may be separate and distinct and unrelated to the merger.

Staff further noted that under the Petitioners' proposal, the post year-2003 savings will be credited to ratepayers only if the Petitioners file a base rate case, but that it is unclear when the next base rate case will be filed. In view of this uncertainty, Staff argued that the Board should adopt the DRA's proposal that net savings be levelized over the ten year period after the merger. However, Staff, unlike the DRA, recommended the use of RECo's currently approved cost of capital of 10.17% rather than the 7.49% figure proposed by the DRA, because the Board has not as of yet modified RECo's overall rate of return in the context of a base rate proceeding.

Staff also argued against Petitioners' proposed recovery of expenses associated with proposed separation packages for certain management employees, because these payments provide generous compensation to management for engineering this merger. In addition, with regard to the so-called "stay payments", Staff argued that Petitioners have not adequately substantiated that critical employees will be driven to voluntarily resign their positions solely as a result of the announcement of the merger. Staff also relied on the Board's decision in I/M/O Jersey Central Power and Light Company (Docket No. ER91121820J, June 15, 1993), wherein the Board denied a request for above the line treatment of three incentive compensation programs that Jersey Central Power and Light Company was offering its managers and officers, thereby rewarding a select group of employees. To further support its position, Staff cited the Board's decision to reject executive separation payments in Conectiv, its most recent merger case involving energy companies. Staff also found no support in the record for Petitioners' proposed employee relocation costs figure of $1 million. In this regard, Staff noted that no organizational charts or specific information related to the employees requiring relocation were provided which would justify such costs.

Based on the above considerations, Staff supported a cost to achieve of $33.638 million ($44.06-$6.922-$2.5-$1.0 million) but also recommended that costs not directly allocated to either O&R or CEI, should be reallocated using a 27.7%/72.3% sharing mechanism with 27.7% going to

O&R and 72.3% to Con Edison rather than the 50/50 split of indirect merger costs between O&R and CEI as proposed by the Petitioners. Staff argued that this approach would lead to more consistency in the allocation of costs and merger related savings.

Staff also expressed a concern that the proposed merger not permit the higher rates (Residential Con Ed vs. RECo rates: 16.6c/kwh vs. 10.814 c/kwh) of Con Edison to contaminate those of RECo to the detriment of the latter's ratepayers. Staff, therefore, concurred with the DRA that in order for the Board to ensure a proper tracking of cost allocations between the two entities, Petitioners should be required to file as a condition of approval of this merger a Cost Allocation Manual with the Board subject to periodic update and review.

Boards Ruling:

In evaluating the impact of this merger on rates, the Board is encouraged by the Petitioners' proffer and acknowledgment that RECo will continue to operate as a subsidiary of O&R and to provide service under its existing tariffs and service requirements. Petitioners have also averred that RECo's rate structure will remain independent from Con Edison's and will be shielded from intrusion by the latter's generally higher operating costs.

To guarantee these assurances, we must at the outset erect a firewall between the costs of the two merging entities as a condition of approving the merger. We concur with the DRA and Staff that this can be accomplished by the Petitioners filing a Cost Allocation Manual with the Board subject to periodic updates as necessary. The Cost Allocation Manual will enable the Board's determination of the functions and services properly assignable to RECo and the prudence of such assignments and their related costs. Therefore, we **HEREBY DIRECT** that RECo file an appropriate Cost Allocation Manual by January 1, 2000 for the Board's consideration.

The primary area of controversy in this proceeding is the estimate of the net merger savings and the method and timing of the sharing of said savings with RECo's ratepayers. In deciding this issue, the Board is mindful of the similarities of the characteristics of this issue in this case and the recently concluded Conectiv merger case. Both mergers produce merger savings primarily via labor reductions and the streamlining of utility operations. The net-savings are estimated over 10-year periods in both cases and similar categories of costs to achieve the merger were identified. We are however mindful in the instant proceeding of the substantial windfall which will accrue to O&R shareholders by reason of a 38.5% appreciation in the value of their investment traceable directly to the consummation of this merger resulting in an approximate $200 million premium, which situation is unique to the instant merger vis a vis Conectiv.

As argued by Staff and the DRA, in a rate case under traditional cost of service methodologies all realized cost savings flow to ratepayers, since rates are based upon the actual cost of service. To the extent a utility realizes cost savings, such savings would be reflected via lower rates, all things equal, in a base rate case. On the other hand, the Board recognizes the effort of the Company in seeking, through this merger, to enhance the quality of service provided its ratepayers. We are also confronted with the similarity of this case with the Conectiv merger and are cognizant of the sharing mechanism that was adjudicated in that case to provide a financial incentive for utilities to pursue beneficial merger opportunities. As a result, we believe that an allocation of 75% of RECo's share of net merger savings to ratepayers is warranted in this instance and is equitable.

The amount of RECo's pro-rata share of gross savings is not in dispute. Staff and the DRA have however urged rejection of some of the costs to achieve the merger as they relate to executive separation costs, stay payments and employee relocation costs totaling $10.422 million. With regard to the separation payments, the Board is convinced by the arguments of Staff and the DRA that these costs are identical to the executive separation payments the Board rejected in the recent Conectiv proceeding. More importantly, we concur with the concerns of the DRA that these costs were engineered by the same managers who engineered the merger itself. Although these costs may be typical management decisions when forming specifications of the merger, we do not consider them reasonable for recovery from ratepayers since the level does not reflect costs associated with the ordinary course of business. Moreover, the record does not support the need to treat them differently in this case. We are also persuaded by the DRA's and Staff's arguments with respect to the stay payments and employee relocation costs.

Therefore, we **HEREBY APPROVE** for the purpose of determining the aggregate net savings from this merger, a cost to achieve of $33.638 million [($44.06-$6.922-$2.50-$1.0)million]. In this regard, we find persuasive the arguments made by Petitioners that directly incurred merger-related costs, such as investment bankers fees, outside legal fees, and consulting expenses, do not vary in proportion to the relative size of the merging companies, and we therefore reject the arguments of the DRA that direct transaction costs should be allocated between O&R and Con Edison in proportion to the allocation of savings. However, we **DENY** the arbitrary 50/50 allocation of indirect merger costs and **DIRECT** Petitioners to reallocate such indirect costs on a 27.7%/72.3% sharing basis consistent with the allocation of savings. Consistency should be maintained, especially in light of the fact that merger savings are the result of cost reductions expected from the merger. Logically, it seems reasonable to apply the same allocation method for costs which are not directly assignable as that which was used for savings. We also **REJECT** the Petitioners' proposed savings distribution and merger cost amortization schedule, because they fail to match the amortization of merger costs with the timing of the flow of net savings by ratepayers.

With regard to the Petitioners' proposed savings distribution and merger cost amortization schedules, we have hereinabove already concluded that the overall level of net savings is understated by approximately $10.4 million due to the adjustments with respect to specific components of the "costs to achieve." With respect specifically to the schedules proposed by Petitioners, we further believe it appropriate, both in terms of a better matching with the realized savings and consistency with our Conectiv decision, that the "costs to achieve" be amortized over 10 years, rather than 5 years as proposed. With regard to the levelization of the net savings over a ten year period consistent with the recommendations of Staff and the DRA, we acknowledge that such approach would be consistent with our Conectiv decision. Similarly, a 75%/25% sharing of the net savings between RECo ratepayers and shareholders would also be consistent with our decision in Conectiv.

However, while the underlying policy considerations in the instant matter are very similar to those with which we dealt in the Conectiv matter, we note certain current circumstances which render our deliberations somewhat unique. Specifically, while in Conectiv we were confronted with the impending restructuring of the electric industry, and were required to deal directly with the issue of what portion of the merger savings to attribute towards that utility's meeting the then Board-directed rate reductions, in the instant matter we are now confronting certain legislatively required rate reductions of at least 5% on August 1, 1999, and at least 10% relative to April 30, 1997 rates by no later than August 1, 2002 and, perhaps more importantly, we are confronted with the reality that the merger-related rate reductions will be implemented virtually simultaneously with the mandated rate reductions required by virtue of P.L. 1999, c.23. In Conectiv, the rate reductions related to the 75% ratepayer share of the levelized net merger savings were implemented in stages starting in January 1998, and were in large part completed by March 1998 upon the closing of the merger. Accordingly, while the merger-related rate reductions were found to be appropriately applied towards the then Board-directed restructuring rate reductions, those merger savings will have been reflected in rates and enjoyed by ratepayers for approximately one and one-half years prior to what are now legislatively-mandated rate reductions.

While we continue to believe that a 25% sharing by Conectiv shareholders was an appropriate incentive to share in these savings, in the instant matter, it is our judgement given the imminence of the mandated August 1, 1999 5 percent rate reduction and the fact that the merger will not be closed until at least April 1999, that there should be no explicit rate reduction related to the merger prior to August 1 of this year. Once the legislatively-mandated rate reduction takes effect, the merger savings will be effectively subsumed within that overall 5% rate reduction and, in later years, within the 10% rate reduction relative to April 1997 rates to be implemented by August 1, 2002. Accordingly, it could be argued that ratepayers will receive the full merger benefits. On the other hand, it could similarly be argued that the Company will have achieved a substantial incentive to pursue the merger in that it will have realized cost savings which assist it in achieving the rate reductions mandated by the Legislature. In light of the above, and the unique circumstances presented due to the substance and perhaps more importantly the timing of this matter, it is our determination that the net merger savings, as adjusted above, not be levelized as proposed by the DRA and Staff, but rather that they be unlevelized as proposed by the Company. We take this position because at the time the statutorily mandated rate reductions are implemented it will be impossible to attribute the rate reductions to any particular source since the 5% to 10% rate reduction far exceeds the merger related savings determined herein. However, initiating a rate reduction at the time the merger is actually consummated, which would be several months in advance of the August , 1999, the date for the mandated 5% rate reduction, and together with the recommended 75/25 sharing of benefits, allows ratepayers to recognize immediately the benefits of the merger while providing the Company with its appropriate share of those benefits.

Therefore, In consideration of the up-front merger rate reductions and the magnitude of the mandated restructuring rate reductions, the Board **HEREBY REJECTS** the DRA's proposed merger rate reduction and **ORDERS** a rate merger reduction equal to $1.434 million or 1.05%, representing 75% of the average of the Petitioners' four year unlevelized net merger savings adjusted to Staff's recommended cost to achieve. This four year average is consistent with the mandated four year transition period in P.L. 1999, C.23 and matches the Petitioners' unlevelized net synergy savings.

Once the four year rate reduction and price cap period provided by P.L. 1999, c.23 expires as of August 1, 2003, the Company will revert to a more traditional rate-making regime, under either traditional Title 48 ratemaking or under an alternative plan for regulation to the extent requested by the Company and approved by the Board pursuant to section 55 of P.L. 1999, c.23 for implementation subsequent to July 31, 2003. Should the Company seek to adjust its base rates, it would have to file a base rate case. Thus, under such ratemaking, to the extent RECo requests to adjust its rates subsequent to July 31, 2003, rates will be established at that time based upon RECo's actual cost of service. To the extent that RECo wishes to resurrect through a base rate case proceeding its proposal to retain a portion of merger-related savings at some point subsequent to July 31, 2003, by setting rates at a level somewhat above the actual cost of service at that time, the Board will not preclude at this time such a proposal. However, the burden at such time will clearly be on RECo to justify a mechanism which sets rates at a level higher than the actual cost of service.

Recognizing that RECo has pending before this Board a petition seeking a 3.6% overall rate increase in its LEAC rates (BPU Docket No. ER98121406), driven primarily by a deferred fuel balance in excess of $5 million, and in order to maintain rate stability leading up to August 1, 1999, we further **ORDER**, simultaneous with the merger-related base rate decrease of 1.05%, that RECo's LEAC rate be increased on an interim basis by an equal dollar amount to that of the base rate decrease. Thus, overall rates will remain unchanged prior to August 1, 1999, but RECo will collect approximately an additional $300 - $400 thousand to apply to the deferred fuel balance.

Impact on Reliability of Service and Utility Employees

Petitioners have maintained that his merger will enable RECo to rely on Con Edison's expertise in performance tracking, systematic operating procedures, remote substation monitoring and outage management systems to assure continued system reliability.

The Division of Ratepayer Advocate

The DRA has expressed concern that merger induced cost cutting not cause a deterioration of service particularly as RECo will, after the merger, constitute only about 2% of CEI's operations as compared to 22% under its current incarnation. It has also cited the lack of a post-merger verifiable and reliable organizational structure as troubling because that places in limbo, the impact of personnel changes on reliability. The DRA therefore, recommends that Petitioners be required to develop objective standards as well as monitoring mechanisms to ensure compliance with reliability standards. The DRA further urges the Board to condition the approval of the merger on the Petitioners retaining 32 employee positions currently situated in New Jersey because it believes that such a measure would guard against the deterioration of service quality and reliability.

Staff

Staff, in its brief, cited Petitioners' testimony that 27 of the 32 New Jersey employee positions are field forces and on that basis urges the Board to require CEI to maintain at least this number of employees in New Jersey to assure reliability until the Company can justify a different level of work force.

Board's Ruling

The Board's continuing ability to monitor reliability of the delivery of service in the territory under its jurisdiction is set forth at N.J.S.A. 48:2-23 and N.J.S.A. 48:3-3 which provides the Board with the authority to ensure that utilities provide safe, adequate and proper service. Recent Staff investigations in the GPU Energy inquiry and in the September 12, 1998 storm inquiry affecting the PSE&G service area have disclosed that the number of work force is an important factor to the rapid restoration of service. Although foreign crews may be available, adequate local crews are important for service reliability. We will continue to exercise our due authority to monitor and ensure that existing reliability and service standards are met post-merger. Therefore, we **HEREBY ORDER** that Petitioners as a condition of approval of this merger, file appropriate annual reports, supported by detailed and complete data and analysis, that clearly and unambiguously show that:

i. RECo continues to meet the requirements of current Law regarding System Reliability; and

ii. those that the Board may impose as a result of the Board's proceeding in the restructuring docket and I/M/O the Petitioner of GPU Energy, Inc., Inquiry in Docket No. EX97080610); related to system reliability and customer service quality.

Concomitant with the concern expressed by Staff regarding field forces in New Jersey, we **DIRECT** RECo to maintain, in the interim period following the merger, at least the 27 field positions currently serving in New Jersey and to justify to this Board if a lower level of work force is expected.

CONCLUSION

By this Order, the Board **FINDS** the merger of Orange and Rockland, the corporate parent of RECo, with Con Edison to be not contrary to the public interest and **APPROVES** the acquisition by Con Edison of RECo. In approving this merger, the Board maintains all of its authority and ability to regulate RECo or its successor electric public utility and its ability to ensure the provision of safe, adequate and proper service to all ratepayers in the affected service territory.

In view of the foregoing, the Board **DIRECTS** that the rate reductions which are associated with 75% of RECo's pro-rata share of the net savings determined herein to be an annual amount of $1.434 million, be implemented as follows:

i. The merger driven rate reduction shall be applied on an equal percentage basis across all rate classes.

ii. The decrease shall be implemented by RECo effective immediately with the consummation of the merger and shall be credited towards the percentage rate reduction in the restructuring proceeding.

iii. Simultaneous with the merger-related base rate decrease, RECo's LEAC shall be increased on an interim basis by an equal dollar amount applied equally across all rate classes.

This Order is issued subject to the following requirements:

1. This Order shall not affect nor in any way limit the exercise of the authority of the Board or the State of New Jersey in any future Petition, or in any proceeding regarding rates, franchises, services, financing, accounting capitalization, depreciation, or any other matter reflecting Petitioners.

2. This Order shall not be construed as directly or indirectly fixing for any purpose whatsoever any value of tangible or intangible assets now owned or hereafter owned by Petitioners.

3. Consummation of the above-referenced transactions must take place no later than ninety (90) days from the date of this Order unless otherwise extended by the Board.

4. Approval of the transactions herein shall not constitute a determination, nor in any way limit, any future determination of the Board, as to the treatment of indebtedness, capital structure and interest expense for rate making purposes in any rate proceeding under state or federal law.

5. A cost Accounting Manual shall be filed with the Board for its review no later than January 1, 2000. This manual shall be subject to periodic update and review, to assure that RECo's rates are shielded from Con Edison's higher costs.

6. The books and accounts of RECo shall be kept separate from those of ConEdison and O&R and the rates charged by RECo shall not be merged with those of ConEdison.

DATED: 4/1/99

BOARD OF PUBLIC UTILITIES
BY:

_____SIGNED___________
HERBERT H. TATE
PRESIDENT

_____SIGNED___________
CARMEN J. ARMENTI
COMMISSIONER

____SIGNED____________
FREDERICK F. BUTLER
COMMISSIONER

ATTEST:

______SIGNED__________
MARK MUSSER, ESQ.
SECRETARY